Supreme Court of the United States

OCTOBER TERM, 1949

No. 55

MANUFACTURERS TRUST COMPANY, as Trustee under an Indenture made by the Debtor under date of September 27, 1933, and individually,

Petitioner,

vs.

REGINE BECKER, EMILY K. BECKER and WALTER A. FRIBOURG,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF OF PETITIONER

EDWARD K. HANLON,
15 Broad Street,
New York 5, New York,
Counsel for Petitioner.

SUBJECT INDEX

Table of Cases Cited

Statutes Cited

Other Authorities Cited

Supreme Court of the United States

OCTOBER TERM, 1949

No. 55

MANUFACTURERS TRUST COMPANY, as Trustee under an Indenture made by the Debtor under date of September 27, 1933, and individually,

Petitioner,

vs.

REGINE BECKER, EMILY K. BECKER and WALTER A. FRIBOURG,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF PETITIONER

Opinions Below

The opinion of the Referee (R. 79-80) is not reported in the Federal Reporter or Federal Supplement.

The opinion of the United States District Court for the Southern District of New York (per Goddard, J.) (R. 91-95) is reported at 80 F. Supp. 822.

The opinions in the Court of Appeals for the Second Circuit (R. 175-188) are reported at 173 F. 2d 944.

Jurisdiction

The order and judgment of the United States Court of Appeals for the Second Circuit, here to be reviewed, was filed on March 3, 1949 (R. 189).

The jurisdiction of this Court was invoked under Section 24 (c) of the Bankruptcy Act and Title 28, United States Code, Section 1254 (1).

Certiorari was granted by this Court on June 6, 1949 (R. 189).

Statement of the Case

This case arose in proceedings under Chapter XI of the Bankruptcy Act in which Calton Crescent, Inc., a New York corporation, is the debtor.

The petitioner, Manufacturers Trust Company, of New York City, is trustee under an indenture made by the debtor under date of September 27, 1933, pursuant to which indenture certain debentures of the debtor were issued (F. 7, R. 70).*

The debtor's only asset was an apartment house, in New Rochelle, New York, known as the Calton Court Apartments which it had acquired in 1933 from a prior corporate owner in an equity reorganization. In that reorganization the debtor was formed to take title to the premises and there were issued to the depositing bondholders of the former corporate owner debentures and stock of the debtor, each such bondholder receiving $50 of such debentures and one share of such stock for each $100 principal amount of the old bonds. (F. 2-6, R. 69-70.)

The reorganization was consummated and the premises conveyed to the debtor on September 27, 1933, and in pursuance of the plan there were issued and are outstanding $254,450 principal amount of the debtor's debentures, plus $2,350 principal amount unissued, held for the con-

---

* Page references to the Transcript of Record are indicated by the letter "R"; references to the findings of the Referee are indicated by the letter "F". Italics are by counsel unless otherwise stated.

version of $4,700 of the old bonds, or a total of $256,800 principal amount of such debentures authorized (F. 8, R. 70). These are the debentures to which we refer above as to which the petitioner is the trustee.

It should be added that in further pursuance of the plan of reorganization, the debtor at the time of its consummation borrowed the sum of $175,000 from the Poughkeepsie Savings Bank, Poughkeepsie, New York, secured by a first mortgage on the apartment house (F. 10, R. 71).

By early 1942 the debtor was in default under the terms of this mortgage (F. 14, R. 71) and during the years 1942, 1943 and 1944 it was in a precarious condition operating continuously at a loss (F. 12, R. 71). On May 23, 1946 the debtor filed in the United States District Court for the Southern District of New York an arrangement petition under Chapter XI of the Bankruptcy Act (F. 35, R. 74).

This case involves the treatment in those proceedings of the claims of the respondents based upon certain of these debentures (R. 2-3), to which claims the petitioner, both in its capacity as trustee under the debtor's indenture and individually, filed objections (R. 3-9). The petitioner, by its objections, seeks to limit such claims to the amount paid by each of the respondents respectively for their debentures.

The amounts of the respondents' claims as filed and the cost to the respondents of the debentures upon which the claims were based are as follows (R. 2-3; Obj. Exs. 11, 12, 13, R. 62):*

---

* We cannot indicate where the various exhibits were offered in evidence, as required by Rule 27 (3) of this Court, because only extracts from the minutes of the hearing were printed in the Court of Appeals, as provided by its Rule 17 (b), and in none of these extracts is included reference to the introduction of the several exhibits referred to in this brief.

	AMOUNT OF CLAIM	COST
Regine Becker	$44,500.00	$3,060.63
Emily K. Becker	52,800.00	5,010.00
Walter A. Fribourg	50,000.00*	2,124.80

The apartment house had been sold prior to the filing of the arrangement proceeding, so that there resulted a complete liquidation of the debtor and the dividends payable to its creditors amounted to 43.61% of the principal amount of their claims (F. 36, R. 74). Consequently there is involved in this case $54,042.10, being the difference between the dividends on the face amount of the respondents' claims and the cost of the debentures to them.

The Basis of the Petitioner's Objections to the Respondents' Claims

The debentures involved in this case were purchased by the respondents in the years 1942 to 1945 (R. 62) and during all of this period the debtor was found by the Referee to have been insolvent "in that the aggregate of its property was not at a fair valuation sufficient in amount to pay its debts" (F. 55, R. 78).

It is the claim of the petitioner that because the debtor was insolvent during the period when the debentures in question were acquired, neither the directors nor persons, such as the respondents, affiliated with them, related to them or acting in conjunction with them, could profit from any dealings in securities of the debtor and at best may

* The claim of the respondent Fribourg as filed was for $55,000. Objection was withdrawn as to $5,000 thereof, costing $480, for reasons which will hereafter appear (F. 38, R. 75).

recover from the estate of the debtor only the amount actually expended by them with interest.

At the time of the acquisition of these debentures two of the directors of the debtor were Sanford Becker and Norman S. Becker who are brothers (F. 18, 20; R. 71-72). The respondent Regine Becker is the mother of these two directors and the respondent Emily K. Becker is the wife of Sanford Becker (F. 27-28, R. 73).

The third respondent, Walter A. Fribourg, was quite close to the Becker brothers. He had known Sanford Becker for many years, both having been connected at one time with the same business (R. 173), and at the time of the transactions at bar Sanford Becker was accountant and secretary of a corporation known as Winsor Buildings, Inc., of which Fribough was president (R. 22-23).* Moreover Fribourg during this period had desk room with the Becker brothers in their office, sharing a room with Norman (R. 21).

It will hereafter be shown that in obtaining control of the debtor and in the acquisition of the debentures here involved the Becker brothers and the three respondents acted in close concert.

The Respondents' Control of the Debtor

The first contact with the debtor by the Becker-Fribourg group (by which term we refer to the Becker brothers and the respondents) was the purchase by Sanford Becker in September, 1941 of $5,000 of these deben-

---

* Sanford Becker testified that he had no financial interest in Winsor Buildings, Inc. (R. 170). Nevertheless he was actively connected with that corporation and not only did work for it and was its secretary but also had power to sign checks on its behalf (R. 170-172). (The exhibits referred to in this part of the testimony are not printed in the Record.)

tures, at which time he acquired also the appurtenant 100 shares of stock (R. 9).* Shortly thereafter in November, 1941 Fribourg purchased $2,000 of the debentures (R. 62). At about this time, in late 1941, because of defaults under the Poughkeepsie Savings Bank mortgage, the debtor had worked out a proposed sale of the property to one Chesterbrook Estates Ltd. for $220,000 (F. 15, R. 71). This sale was opposed by Sanford Becker and Walter A. Fribourg, the former bringing a suit to enjoin it upon the ground that the property had substantially greater value (R. 9-11, 22; F. 16, R. 71).

At a meeting of stockholders held on February 17, 1942 the proposal failed to receive the requisite two-thirds vote of the stockholders and so was defeated (R. 12; F. 17, R. 71). This action of the stockholders was in conjunction with a written offer made by Sanford Becker on behalf of "a client" to cause $15,000 to be loaned to the debtor to meet the mortgage arrears (R. 60-61), tied in with the condition that the lender be permitted to name two directors (R. 14). While the identity of the lender was not disclosed at the time, Sanford Becker testified in this proceeding that "a client" referred to the three respondents (R. 12).**

The $15,000 loan was thereafter made in the name of Baset Realty Corporation (hereinafter sometimes called "Baset") which was organized for this particular trans-

* It was stipulated that transactions in the debentures included automatically the appurtenant stock (R. 22).

No objection was filed to Sanford Becker's claim on these debentures because they were purchased prior to his becoming an officer and director of the debtor.

** Mr. Becker's proposal provided that any and all stockholders be permitted to participate in the loan if they so desired. None of them did so, a not unexpected result in view of the fact that it is not disputed that no interest had ever been paid on the debentures.

action and was owned and controlled by the respondents (F. 20, R. 72). Baset later assigned to each of them a one-third participation in the mortgage (R. 13).

The Baset mortgage was closed on April 7, 1942 (R. 14) and at the same time Sanford Becker and Norman S. Becker became directors of the debtor as Baset's nominees, *i.e.*, as the nominees of the respondents (R. 15-16).

The Baset loan also carried the condition that Baset be permitted to designate a new managing agent for the property (R. 60-61) and a new managing agent was thereupon designated by Baset (R. 15-16).

Furthermore, at this same meeting on April 7, 1942 Sanford Becker was elected Treasurer of the debtor and Norman S. Becker, Secretary (R. 16), and it was provided that the principal office of the debtor be moved to the treasurer's office at 11 West 42nd Street, Manhattan, New York City (*i.e.*, the office occupied by Sanford Becker, Norman S. Becker and Walter A. Fribourg) and it appears without dispute that from that time on the office was there maintained (R. 16-17).

It is apparent that as a result of these steps the Beckers had effective control of the situation, for their managing agent was operating the property, they had the books and records of the debtor and the debtor's affairs were conducted from their office. Yet at this time the only securities owned by any of this group were Sanford Becker's $5,000 of debentures and a like amount of debentures owned by Walter A. Fribourg (who had purchased them in November of 1941 and March of 1942) (R. 62.)*

* This $5,000 of debentures purchased by Fribourg are the debentures in that amount which we have previously stated were eliminated from the objections filed to his claim. This was because their purchase antedated the time when the Beckers became directors and the Becker-Fribourg group took over control of the debtor.

In October of 1943, there having been a default under the Baset mortgage, Baset took an assignment of rents (F. 22-23, R. 72) and thereafter the actual physical operations of the property were completely under the control of Baset as mortgagee in possession, functioning through its own managing agent (R. 19).

On June 28, 1944 the three remaining directors (there were five in all) resigned and Sanford Becker's secretary and two friends filled the vacancies, so that from that time on the entire board of directors was completely Becker-Fribourg controlled (R. 17-19). At the same time that the Becker-Fribourg group obtained the whole board of directors, Norman Becker became President of the corporation and has since continued in that capacity (R. 19; F. 52, R. 77).

The Acquisition of Debentures by the Respondents

While the Becker-Fribourg group was obtaining control of the debtor there was also carried out a concerted plan to purchase the debentures which now form the basis of the respondents' claims.

All of the purchases of the respondent Regine Becker were made through an account in the name of Fribourg maintained with one E. Henry Sondheimer & Co. (R. 41-42, 62) and part of the debentures of the respondent Emily K. Becker were acquired in the same fashion (R. 41-42, 66). The respondents Regine Becker and Emily K. Becker exercised no judgment of their own in purchasing their debentures, their purchases having been handled by Sanford Becker as their agent (F. 53, R. 77).

A considerable part of Fribourg's debentures were acquired as a result of a circular letter sent to the other debenture holders in 1944 under the name of his brother-in-law, one Winter, handled through a bank account

opened in Winter's name (R. 31-33, 62). Winter himself testified that he knew nothing of the apartment house in question, had never seen it and did not know anything about the debtor's affairs (R. 48). Moreover, he had no conversation with Fribourg with respect to the transaction (R. 48). He went to the bank with Norman Becker and opened the account upon his introduction and it was Norman Becker who put the money in the bank (R. 48-49). Bank statements and cancelled checks on the account, when received from the bank, were turned over by Winter to Norman Becker (R. 49-50). The mechanics of these maneuvers appear to have been worked out by Sanford Becker (R. 27-31).

These transactions make it clear that the Beckers and Fribourg were acting together, and that the whole operation was a matter of close cooperation and joint action.

Relationship of the Respondents and the Debtor's Directors

There can be no doubt that there was an active relationship between the Beckers and Fribourg, manifesting a complete and understanding concert, and that the Becker brothers, the two Becker ladies and Fribourg were acting as a single group.

As to the Becker ladies the Referee found (F. 53, R. 77):

> "Sanford Becker and Norman Becker acted as agents for the Becker ladies in the purchase of debentures by them. And while Sanford consulted with his mother and wife from time to time as to such purchases, the proof does not warrant a finding that the ladies exercised any discretion of their own in such purchases."

The Referee concluded as a matter of law that the proofs of debt of the Becker ladies "should be treated as

if they were proofs of debt filed by directors of debtor" (Third Conclusion, R. 78).

The District Judge in his opinion expresses no dissent from the Referee's finding (cf. R. 93) and the majority opinion in the Court of Appeals states (R. 185):

> "As respects the Becker ladies, since they exercised no independent judgment in the investment of their funds, they are chargeable with the knowledge of their agent, Sanford Becker."

In his dissenting opinion in the Court of Appeals, Judge Learned Hand said of the Becker ladies (R. 188):

> "They relied altogether upon the directors' advice and exercised no judgment of their own in deciding to buy. In so doing I think that they became charged with the same equities that would have charged the directors, had they bought on their own behalf. In short, the directors could not pass on to their principals profits which they could not have retained for themselves. The principals were charged with notice of what the agents knew, and therefore the principals were not bona fide purchasers."

As to Fribourg, he maintained his office in the suite occupied by Sanford and Norman Becker at 11 West 42nd Street, New York, N. Y. and shared a room there with Norman Becker (R. 21). This incidentally put him in a position to be constantly and fully advised of the debtor's affairs, and as a matter of fact Fribourg reluctantly admitted discussing the debtor's affairs with the Beckers from time to time (R. 23-24).

As we have pointed out, all of Regine Becker's debentures and part of Emily K. Becker's were purchased by Sanford Becker through Fribourg's account with Sond-

heimer, and a substantial part of Fribourg's debentures were purchased through Winter under the supervision of Norman S. Becker. Furthermore Fribourg and the Becker ladies had made substantial advances through Baset to the debtor, and Sanford and Norman Becker as directors were the nominees of Fribourg as well as of the Becker ladies.

While the Referee found as a conclusion of law that Fribourg's proof of debt "should not be treated as if it were a proof of debt filed by a director of debtor" (First Conclusion, R. 78), the District Court said (R. 93) that he was persuaded "that the evidence warrants a finding that the relationship between Fribourg and the Beckers (directors) was of such a nature with respect to the affairs of the debtor so as to treat his proof of debt as a proof of debt of a director".

The majority opinion of the Court of Appeals held that Fribourg did no more than to invest his own funds on a "tip" received from an officer or director of the debtor (R. 185). Judge Learned Hand expressly refrained from discussing the matter (R. 187).

We contend that the claims of all three respondents should be treated as though they were claims of directors of this insolvent debtor.

Lack of Disclosure to the Selling Debenture Holders

The petitioner's objections to the claims of the respondents were based not only on their disqualification to profit in this instance, but also upon the contention that the respondents had acquired the debentures in question by taking advantage of their knowledge as insiders without appropriate and adequate disclosure to the sellers of such securities (R. 7).

The petitioner in support of this contention asserted that the Becker-Fribourg group had failed to reveal to the selling public (1) the very definite prospect that the property could be sold for an amount which would permit of a liquidating dividend substantially in excess of the figure at which the security holders were selling, (2) the identity of Baset with the Becker-Fribourg group, and (3) that insiders were buying the securities.

The Referee overruled this contention (F. 54, R. 77-78). The District Court held that the record did not show that this finding was clearly erroneous (R. 95), a conclusion in which both the majority and minority of the Court of Appeals agreed (R. 182, 186), and consequently, as the matter is factual, the contention is not pressed in this Court.

However, a brief reference to this phase of the case is necessary for a better understanding of the entire situation, and more particularly of certain comments in the two opinions in the Court of Appeals (R. 181-183, 186-187).

Sanford Becker testified that after the $220,000 offer was defeated in 1942, and up to the time of the ultimate sale in early 1946, inquiries with a view to the purchase of the property were received "once a month at least" (R. 20). From the Referee's decision (F. 41, R. 75-76) it is apparent that these inquiries and the offers were in an ever increasing amount, ranging from $240,000 to $280,000. The latter figure was rejected by Norman Becker who stated that he thought $300,000 should be the price (F. 41, R. 75-76), and, as a matter of fact, that is the figure at which the property ultimately was sold (F. 33, R. 74). As a sale at that price resulted in a liquidating dividend of 43.61%, it is perfectly obvious that the other

holders of the debtor's securities would not have sold at prices as low as 3%, had they had any true idea as to the possibilities. Further, had the public had any idea that it was the insiders who were buying the securities, they would have had a like reluctance to part with them.

The respondents upon the trial made no effort whatever to demonstrate that any information with respect to the constant purchaser interest in the property ever was disclosed to the debtor's security holders. It was however contended by the respondents that four of the sellers of securities had knowledge of the situation. The four in question were the King Estate, the Y.W.C.A., Mr. Kelly (the president of the debtor) and Mr. Hays (a director). There is nothing in the record to demonstrate that they were at any time informed of the inquiries and offers being received, nor did the respondents attempt to put any of them on the stand to demonstrate that they did have such knowledge. The only thing which they may have known and which the other public security holders did not know was that the Becker-Fribourg group was purchasing some of the securities.

There is no evidence anywhere in the record that the identity of the Becker-Fribourg group with Baset ever was disclosed and Miles Amend, an attorney who handled the Baset loan for the debtor, testified that to his best recollection there was no such disclosure (R. 45-47).

The Sale of the Property

In October 1945 a contract was made for the sale of the property at a total price of $300,000.00 and title was closed on January 8, 1946. The purchase price was paid by the purchaser taking subject to the then balance of $154,000 on the Poughkeepsie Savings Bank's mortgage, by cash

of $70,000 and by a purchase money mortgage of $76,000 (F. 33, R. 74).

This purchase money mortgage was subsequently sold pursuant to an order of the court for the sum of $66,000 (F. 34, R. 74).

It was in consequence of the sale of the property and the subsequent sale of the purchase money mortgage that sufficient cash was realized to permit of a dividend to the creditors of 43.61% of the principal amount of their claims (F. 36, R. 74).

The Questions Presented

As stated in the petition for certiorari, the questions here presented are whether directors of a corporation may purchase its debt securities while it is insolvent and enforce them in bankruptcy at their full face value rather than be limited to the actual cost; and, if not, whether their relatives and business associates may, in cooperation with these fiduciaries, do what the directors themselves may not do.

The Grounds on which the Decisions of the Courts Below Rested

The Referee, the District Court and the Court of Appeals (L. Hand, Ch. J. dissenting) all overruled the petitioner's objections, but no two of them agreed upon the basis for their conclusions.

The Referee's opinion is printed at pages 79-80 of the Transcript of Record, the opinion of the District Court at pages 91-95; the opinion of the majority of the Court of Appeals at pages 175-186 and the dissenting opinion at pages 186-188.

The Referee took the position that, with certain exceptions not here pertinent, a director, and consequently his associates, may acquire unmatured obligations of the corporation of which he is a director and enforce them for their full face amount, even if at the time he so acquired the obligations the corporation was insolvent. The Referee based his conclusion principally upon this Court's first decision in *Securities and Exchange Commission* v. *Chenery Corp.*, 318 U. S. 80, a case which was not in point, involving as it did the reorganization of a public utility under Sections 6 and 11 of the Public Utility Holding Company Act of 1935, where the subject company was not insolvent but was being reorganized in order to divest itself of certain subsidiary companies in accordance with the provisions of that statute.

In the District Court, Judge Goddard held that cases condemning transactions by directors in the debt securities of an insolvent corporation did not cover the situation where the corporation, although insolvent in a bankruptcy sense, is still a "going concern", applying what he deemed to be the rule as laid down in decisions of the New York courts (R. 94).

The prevailing opinion of the Court of Appeals was written by Swan, C. J., Chase, C. J. concurring. The dissenting opinion was written by Learned Hand, Ch. J.

The majority took the position that the matter was not governed by decisions of the New York courts since the bankruptcy law, including what the federal judges think to be equitable, determines what dividends shall be distributable to a claimant (R. 176-177); that the wrong, if any, had been done to those who had sold their claims at a price less than the dividend they would have received had they retained them (R. 184); that where, as here,

the contest is between the unwronged cestuis (i. e., the debtor's other creditors) and the directors, if the former are to prevail it can be only as a disciplinary measure (R. 184); that if the doctrine be recognized as a disciplinary sanction within the discretion of the court to impose or withhold, then each case should depend on its own circumstance, and consequently in the case at bar, where there was no overreaching of the sellers, the majority was not convinced that the circumstances were such as to require the imposition of the sanction, even if the proofs of debt had been filed by directors of the debtor themselves (R. 184-185).

The majority stated further that these particular respondents were not directors or officers of the debtor, that their own funds were invested, and that no officer or director of the debtor had any interest in the debentures purchased; that as to the Becker ladies, while they exercised no independent judgment and are chargeable with the knowledge of their agent, Sanford Becker, there was no overreaching of the sellers; and that as to the respondent Fribourg, there was nothing in the record to justify a finding that he did more than invest his own funds on a "tip" received from an officer or director of the debtor (R. 185-186).

Judge Learned Hand in dissenting took the position that if equity regards the bonds as improperly acquired it is more nearly just to distribute any profits among the other creditors, who have not been paid in full, than to leave them in the directors' hands (R. 186); that no fiduciary deals with his beneficiary on terms of equal advantage, and that if he is to avoid that restriction he must be able to point to some circumstance which will excuse him (R. 187); that there was a distinction to be

taken between purchasers of stock and purchasers of debt securities (R. 187); that before accepting the excuse in the case of debts the burden should be put on the director of proving not only that he genuinely expected by a composition to continue the business but that his expectation was well founded, and that nothing short of both would serve as an excuse, and that neither was proved in the case at bar (R. 188).

As to the Becker ladies, Judge Hand felt that they were chargeable with what their agents knew and were not bona fide purchasers (R. 188). As to Fribourg, Judge Hand stated that the correct answer was not altogether clear but it would have been necessary to find it only in case the majority had agreed with his disposition of the chief issue (R. 188).

Summary of Argument

I

Directors of a corporation may not purchase its debt securities while the corporation is insolvent and enforce them in bankruptcy at their full face value, but are limited to the actual cost of such securities and interest.

> As a matter of principle directors should not be permitted to enforce at face value debt securities of their corporation purchased when the corporation is insolvent.
>
> Previous Federal decisions on this subject have uniformly followed this principle.
>
> Other authorities are to like effect.
>
> That such a result will not make whole those from whom the securities are purchased, but rather

will inure to the advantage of the estate and, therefore, to the non-selling debenture holders, is beside the point. Likewise it is of no consequence that no harm was done to the debtor.

The Referee and the District Court erroneously relied upon certain New York decisions, which are neither in point nor authoritative in a bankruptcy proceeding.

The Referee misapprehended this Court's decision in *Securities and Exchange Commission* v. *Chenery*, 318 U. S. 80.

The District Court erroneously applied a so-called "going concern" theory.

II

As the directors themselves were disqualied to purchase the debt securities of their insolvent corporation, such persons as these respondents, related to them, affiliated with them or acting in conjunction with them, likewise cannot profit from any dealings in such securities.

ARGUMENT

I

Directors of a corporation may not purchase its debt securities while the corporation is insolvent and enforce them in bankruptcy at their full face value, but are limited to the actual cost of such securities and interest.

We first discuss the problem at bar upon the assumed hypothesis that the purchases in question were made by directors themselves. We do this because, if directors

may make such purchases with impunity, we do not reach the problem of the treatment to be afforded these respondents.

As a matter of principle directors should not be permitted to enforce at face value debt securities of their corporation purchased when the corporation is insolvent.

It is not disputed that during all the period when the respondents purchased the debentures here involved the debtor was insolvent in the bankruptcy sense (cf. F. 55, R. 78).

That the debtor was insolvent also in the equity sense is manifest not only from the Referee's finding that during the years 1942, 1943 and 1944, when most of the debentures were acquired,* it was in a precarious condition operating continually at a loss (F. 12, R. 71) but also from the chart introduced by the respondents (Resp. Ex. 17, R. 68) which shows that this condition continued throughout the year 1945.

Finally it is not disputed that the respondents' debentures, aggregating in face amount $147,300.00, were acquired for a total purchase price of $10,195.43.

It is elementary that directors undertake a fiduciary obligation, of which this Court said in *Pepper* v. *Litton*, 308 U. S. 295, 307 (1939):

> "For that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation-creditors as well as stockholders."

Manifestly, the fiduciary obligation of directors is the greater when his corporation is insolvent and when its

* See statement of purchases, R. 62.

financial affairs are precarious. Whatever may be the extent of the director's obligations when the corporation is conducting its business in ordinary fashion, the impact of insolvency throws upon the director the urgent duty of considering what steps are to be taken to protect the best interests of his corporation, its stockholders and its creditors.

The Securities and Exchange Commission, in a brief as *amicus curiae* in the Court of Appeals, wrote in support of the petitioner's position as follows:

> "In our opinion the district court failed to appreciate the significance of the state of insolvency, irrespective of the pendency or imminence of the bankruptcy proceeding, and of the effect of insolvency upon the duties of directors and their relationship to the corporation, its creditors and stockholders. Insolvency by its very nature places the corporation in the field to settle its indebtedness. From that point on, any purchase of debt securities by a director is fraught with potential conflicts of interest. The directors of the corporation, at least in the absence of action by creditors, must determine whether or not to institute a statutory proceeding such as filing a voluntary petition under the Bankruptcy Act. They may decide to undertake direct negotiations with the corporation's creditors for adjustment of its debt, possibly in connection with efforts to seek fresh capital. In any event, the determination of what should be done, and when, is for the directors to make in the best interests of the corporation."

The majority of the Court of Appeals could see no reason why there should be a difference between the director's position when his corporation is solvent and when it is insolvent, saying (R. 183):

"It is not immediately apparent why insolvency should make a difference. It will cost the debtor no more whether the dividend which it may be able to pay creditors goes to the original holder of the debt or to a director-assignee."

Once liquidation occurs the identity of the creditor may, to be sure, be immaterial, but the conduct of directors, who are buying an insolvent corporation's debt securities at depressed prices, may make a substantial difference one way or the other to the corporation and its creditors. What is to prevent directors from taking a certain line of action, or none at all, until they have corralled all of the debt securities they can? The directors of an insolvent corporation, faced with all the problems that insolvency creates, must keep themselves in a position where there will be no conflict of interest between their position as creditors and the welfare of the entire community of interests in the corporation. Claims which directors may have acquired when the corporation was solvent may, of course, present some conflict of interest once the corporation has become insolvent; but where after insolvency has occurred directors make purchases of claims they are deliberately creating the conflict. Having done so, directors should not be permitted to profit, and such has been the uniform rule in the federal courts until the decisions below in the instant case.

Judge Learned Hand pointed this out in his dissenting opinion below where he said (R. 187):

"The claimants in the case at bar argue that, since directors may freely buy shares in the market, they must be equally free to buy debts from creditors after insolvency, when, as I have just said,

creditors step into the place of shareholders. That there is at least a prevailing belief in the federal courts to the contrary, the decisions discussed in my brothers' opinion make clear; they form a substantial body of opinion, which *Securities and Exchange Commission* v. *Chenery** did not disturb."

Previous Federal decisions on this subject have uniformly followed this principle.

The question has been considered by the Courts of Appeal for the Sixth, Seventh and Tenth Circuits and in every instance the purchasing directors were limited to the amount paid by them for their claims. In none of these cases was it deemed material whether or not bankruptcy proceedings had already begun. As a matter of fact in one case the reorganization proceedings did not commence until a year after the transaction, in another the corporation was in state receivership but not in bankruptcy, and in the third bankruptcy proceedings had begun when the claim was acquired. Moreover, in the first two of these cases certiorari was denied by this Court.

These three cases are *In Re Van Sweringen Company*, 119 F. 2d 231 (6 Cir. 1941; cert. den. *sub nom. Terminal & Shaker Heights Realty Co.* v. *Van Sweringen Company*, 314 U. S. 671); *In Re Norcor Manufacturing Co.*, 109 F. 2d 407 (7 Cir. 1940; cert. den. 310 U. S. 625); *Monroe* v. *Scofield*, 135 F. 2d 725 (10 Cir. 1943). We will discuss them in that order.

In Re Van Sweringen Company.—There the Vaness Company was the majority stockholder of two debtor companies, one of which in turn owned all the stock of the Cleveland Terminal Building Company, another of the

* 318 U. S. 80

debtors. The Van Sweringen brothers were officers and directors of all these companies. In May, 1930, the Vaness and Cleveland companies borrowed $39,500,000 from J. P. Morgan & Company evidenced by notes and secured by certain collateral securities. Upon default on the notes in May, 1935, the collateral securities were to be sold at public auction in September. In August of the same year, the Van Sweringens formed the Midamerica Corporation whose successor was the claimant in the proceeding. The agreement setting up this corporation provided that one Ball and one Tomlinson would put up $2,000,000 and the Van Sweringens would have an irrevocable option to purchase 55% of the common stock for a period of 10 years and obtain control of the board of directors. At the auction sale Midamerica bought in the notes of the debtor together with the collateral securities which were conceded to have a value greater than the total amount paid. The notes of the three debtors purchased were carried on Midamerica books at $1, $2 and $887, respectively. The claimant sought in the debtors' reorganizations to enforce a claim on these notes at their total face value of $39,500,000.

That the reorganizations of these debtors did not commence until somewhat over a year later, *i.e.,* October 19, 1936, does not appear in the opinion, apparently because the court did not regard the pendency of reorganization proceedings as a material factor. We obtain the date of the commencement of these proceedings from *Gochenour v. Cleveland Terminals Bldg. Co.,* 142 F. 2d 991, 992 (6 Cir. 1944).

The court held that the claims were to be limited to $1, $2 and $887 plus interest from the date of acquisition, saying at page 234:

"From the manner and under the circumstances in which, in association with outside enterprisors, the Van Sweringens, as directors of insolvent corporations, purchased these claims against their cestui que trustent, the debtors, herein, at substantially less than real values, equity and good conscience demand that the claims of their corporate creature, Midamerica (predecessor to appellant), be limited to the amounts actually paid by it for the notes and bonds of the insolvent corporations. (*Citing cases.*)

As expressed by Chief Judge Cardozo in Meinhard *v.* Salmon, 249 N. Y. 458, 464, 164 N. E. 545, 546, 62 A.L.R. 1: 'Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. * * * Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.' We uphold the standard of this doctrine."

In Re Norcor Manufacturing Co.—There one Krueger was the principal stockholder and director of the Norcor Manufacturing Co., the debtor, which had confessed insolvency in a state court. Ten months later Krueger hired an attorney, one Lehner, for the purpose of reorganizing the debtor. Lehner was furnished with a list of stockholders, financial statements and other pertinent

data and he then solicited creditors of the debtor, offering to purchase their claims at 10 to 30% of their face value. Krueger assigned his controlling stock to a third person who reassigned the same to the Norcor Company, a new corporation whose board of directors was controlled by Krueger and Lehner. Lehner continued to offer to purchase such claims and assignments of such claims were made to Lehner, his wife, Krueger and Krueger's son, all of whom reassigned such claims to the new corporation. These claims totaled $65,016.73, for which amount the new company made a claim in the debtor's reorganization. The actual amount paid for such claims was $13,331.13.

The court limited the claims to the amount actually paid for them, saying (p. 411):

> "It is argued that Krueger and his attorney Lehner sustained such a fiduciary relation with the debtor corporation as would preclude them from purchasing claims of creditors at a small fraction of their face value, and using them as the foundation for a claim in excess of that actually paid therefor. We think this argument is sound. Certainly Krueger, as Managing Director, occupied such position."

The court then quotes from this Court's opinion in *Pepper v. Litton, supra*, and continues:

> "As Krueger occupied a fiduciary relation, so did his attorney Lehner. Neither of them would have been entitled to the allowance of a claim in an amount which would have inured to his individual profit. Being thus precluded as individuals, they had no right to accomplish the same purpose under the guise of a corporate entity."

Monroe v. *Scofield.*—There a director purchased a judgment against his corporation after the commencement of bankruptcy proceedings against it. The court limited the claim to the amount paid, saying (p. 728):

> "Where a corporation is a going concern, a director may purchase a claim against the corporation at a discount and enforce it for the full amount, absent a present duty on his part to act for the corporation. However, where the corporation is insolvent, he is precluded from recovering more than he paid for the claim unless by an order of the court or otherwise he has been shorn of all power in the corporate management and his trust relationship has been fully terminated."

We know of no decisions in any federal Court of Appeals contrary to the result reached in the foregoing three cases except the case at bar. Here the majority of the Court of Appeals held that the application of the rule could only be as a disciplinary measure for wronging someone (the sellers) who had not complained of the wrong and concluded that as there was no overreaching of the sellers it was not convinced that the circumstances were such as to require imposition of the sanction, "even if the proof of debt had been filed by a director of the debtor" (R. 184-185).

This is an entirely new and startling conception, which ignores this Court's statement in *Pepper* v. *Litton, supra,* that the standard of fiduciary obligation is designed "for the protection of the entire community of interests in the corporation". The court below was not oblivious of the contention that insolvency creates a conflict between duty and the personal interests of the directors (cf. R. 183) but nevertheless expressly held the test to be one of "over-reaching of the sellers".

The criterion of insolvency, as adopted in the three decisions of the Courts of Appeal above discussed, has also been the criterion which has been uniformly adopted by the District Courts.

The most complete discussion of this subject in the District Courts appears in *In Re Los Angeles Lumber Products Co. Ltd.*, 46 F. Supp. 77 (D.C., S.D., Cal., 1941),* and because the case is so apposite in its facts we refer to it at some length.

There one Faries had represented certain holders of the debtor's bonds and was secretary and counsel of an informal bondholders' committee. An immediate reorganization of the debtor company was contemplated but at the time no such proceedings were pending. Faries was elected a director and vice-president and appointed general counsel for the debtor in June, 1936, which positions he occupied until after confirmation of the plan in 1940.

Until July, 1937, as part of the contemplated reorganization, Faries had purchased bonds for the account of the debtor with funds supplied by one of its subsidiaries. In July, 1937, these funds ran out and Faries then and prior to December, 1937, purchased $14,500 principal amount of bonds for $1,512.10 with the intention of delivering them to the debtor if it should have other funds, a contingency which never occurred. A petition for reorganization was filed on January 28, 1938.

During the pendency of the reorganization proceedings Faries purchased other bonds of the debtor alone and in conjunction with a brokerage firm (District Bond Com-

* This opinion was rendered subsequently to the decision of this Court in *Case* v. *Los Angeles Lumber Products Co., Ltd.*, 308 U. S. 106 (1939).

pany), some of such purchases being made from the president of the company and associates of his. Also the brokerage firm solicited bonds from some of the sellers by the use of post-cards and by this means some purchases were made without revealing the identity of the purchasers.

After confirmation of the plan a bondholders' committee moved to cancel or reduce Faries' and District Bond's claims on the bonds referred to above.

The court (Jenney, J.) held that Faries as a director, officer and counsel was a fiduciary and could make no profit on securities of the debtor while acting in that capacity and that District Bond, having full knowledge of Faries' position, would be treated in the same manner. Accordingly, the claims of Faries and District Bond were limited to what they had paid for the bonds plus six percent interest from the date of acquisition.

The factual similarities between the *Los Angeles Lumber Products Co.* case and the instant case are striking.

When Faries purchased the first of the bonds which he retained for himself, there was no competition with the debtor for the debtor's funds had been exhausted. Even though Faries made these purchases with the intention of delivering them to the debtor if it should acquire other available funds, yet his recovery thereon was limited by the court.

Moreover, the early purchases were made before any reorganization proceedings were pending.

In both cases some securities were purchased in the open market.

In the instant case Fribourg made purchases from the president and another director of the debtor; in the *Los*

Angeles Lumber case Faries made purchases directly from the secretary to the company's president, and also made purchases in conjunction with District Bond Company from the president himself and associates of the president. The District Bond Company was cognizant of Faries position in the matter (as were the respondents of the situation in the instant case) and therefore was held disqualified.

There is one striking dissimilarity, which is that, whereas in the instant case every effort was made to minimize the debtor's prospects, in the *Los Angeles Lumber* case Faries from the beginning advised everyone who inquired not to sell their bonds.

The opinion in the *Los Angeles Lumber* case contains a very complete citation of authorities. The opinion is quite long and we quote merely the following (p. 88):

> "From these references it will be seen that the rules laid down by the courts are designed 'to provide against any possible selfish interest exercising an influence which can interfere with the faithful discharge of duty which is owing in a fiduciary capacity' (Magruder v. Drury, 235 U. S. 106, 119, 35 S. Ct. 77, 82, 59 L. Ed. 151) and these rules have long been strictly enforced (Michoud v. Girod, 45 U. S. 503, 4 How. 503, 557, 11 L. Ed. 1076), and they are required 'because of the demonstrated fallibility of mankind'. (Loring, A Trustee's Handbook, Shattuck Revision, p. 66.)
>
> It has, of course, long been established that officers, directors and attorneys of a corporation are fiduciaries and that they should be held responsible for any breach of duties as such. *They may not, while the corporation is insolvent, purchase claims against it at a discount and then enforce such claims at their full face value.* Bonney

v. Tilley, 1895, 109 Cal. 346, 42 P. 439; Davis v. Rock Creek Lumber, etc., Co., 1880, 55 Cal. 359, 36 Am. Rep. 40. When the corporation is not only insolvent but has filed its petition under Section 77B or Chapter X of the National Bankruptcy Act as amended, 11 U.S.C.A. §501 et seq., and the directors have become trustees of the debtor in possession, the directors' obligations as trustees become even more rigorous. In re Norcor Mfg. Co., 7 Cir., 109 F. 2d 407; Pepper v. Litton, 308 U. S. 295, 60 S. Ct. 238, 84 L. Ed. 281.

The good faith or innocent motives of the fiduciary, or his well-intentioned purpose to effectuate a plan of reorganization, constitute no defense to liabilities founded upon breaches of fiduciary obligations. In re McCrory Stores Corp., D.C. S.D. N.Y., 1935, 12 F. Supp. 267, 269, 30 Am. Bankr. Rep., N. S., 670.

* * * * * * *

And it is likewise no defense to say that fraud was not intended and that unfairness did not result from the trustee's actions Magruder v. Drury, 235 U. S. 106, 120, 35 S. Ct. 77, 59 L. Ed. 151; Jackson v. Smith, 254 U. S. 586, 589, 41 S. Ct. 200, 65 L. Ed. 418; Tomblin v. Hill, 206 Cal. 689, 275 P. 941. Actual fraud in such cases is not necessary to give the client redress. A breach of duty is constructive fraud. Baker v. Humphrey, 101 U. S. 494, 25 L. Ed. 1065. There are many situations, in which a constructive trust is imposed even in the absence of fraud. 3 Scott on Trusts, §462."

In *In Re Jersey Materials Co.*, 50 Fed. Supp. 428 (D.C., N.J., 1943), the debtor was organized by one Schweyer and one Krohn in 1933. At that time it purchased its property, making part payment therefor by a real estate mortgage in the sum of $3,500. This mortgage was not

paid at maturity in 1936 and by 1941 "the affairs of the bankrupt were in a precarious state". However, the debtor concluded an agreement with the owners of the mortgage which provided *inter alia* that they would take preferred stock in place of the mortgage. This agreement was never consummated and in October, 1941 one Connor purchased the mortgage for $1,600 and spent in incidental expenses an extra $100. On February 16, 1942 an involuntary petition in bankruptcy was filed against the debtor and it was adjudicated a bankrupt in March, 1942.

The underlying facts in connection with Connor's acquisition of the mortgage were that the owners thereof informed Schweyer that they would sell the same at a discount and Schweyer, having been advised by his attorney that he could not legally acquire the same himself since he was a director, urged Connor to make the purchase which the latter did with money loaned to him by Schweyer. Connor was at all times cognizant of the position of Schweyer and of the finances of the debtor. Connor sought to enforce in the bankruptcy proceedings the mortgage at its face value while the trustee in bankruptcy sought to limit his claim to the amount paid by him for the mortgage.

The court (Forman, J.) held that Connor's claim would be limited to the amount which he had paid for the mortgage, namely, $1,700.

In the *Jersey Materials* case, as with the debentures in the instant case, the acquisition of the mortgage occurred prior to any bankruptcy proceeding, but at a time when the finances of the corporation, to use the language of the court in that case, "were in a precarious state", which is almost the precise language used by Referee Olney to describe the situation of the instant debtor (F. 12; R. 71).

In Re Philadelphia & Western Ry. Co., 64 F. Supp. 738 (D.C., E.D., Pa., 1946) involved purchases by directors of a corporation in reorganization under former Section 77B of the Bankruptcy Act where no trustee was appointed, the debtor having continued in possession under management of directors approved by the court. During the reorganization period certain of these directors and others standing in various relations to them purchased bonds of the debtor. While this presents an extreme case the opinion of the court (Kirkpatrick, J.) is illustrative of the decisions of the Federal Court on the general subject.

After pointing out that directors of a solvent corporation may purchase its debt securities at a discount and enforce them for their full amount, the court went on to say (p. 740):

> **"If, however, the corporation becomes insolvent, the duties and obligations of the quasi-trusteeship become more closely assimilated to those of regular trustees. This may be partly due to the influence of the frequently repeated generalization that the assets of an insolvent corporation are a trust fund for the benefit of the creditors, and partly to the fact that, when the corporation is insolvent, ownership of its obligations, particularly its mortgage bonds, comes very close to being the full equivalent of ownership of its assets. At any rate, courts of equity, administering the affairs of such corporations, have set a standard of conduct stricter than that 'permissible in a workaday world', Meinhard *v.* Salmon, infra. When bankruptcy follows insolvency and the debtor is left in possession without the intervention of a trustee, the directors, holding office under Court appointment or Court approval, become in all respects, so far as their**

fiduciary obligations are concerned, the full equivalent of a trustee in bankruptcy. ~~In~~ re Los Angeles Lumber Products Co., D.C., 46 F. Supp. 77; In re Cheney Bros., D.C., 12 F. Supp. 605; In re James Butler Grocery Co., D.C., 12 F. Supp. 851. As such, they may not traffic, to their own profit, in either the assets or the obligations of the debtor. In re McCrory Stores Corp., D.C., 12 F. Supp. 267; Monroe v. Scofield, 10 Cir., 135 F. 2d 725."

In *In Re McCrory Stores Corporation*, 12 F. Supp. 267 (D.C., S.D., N.Y., 1935), the issue involved was as to the fairness of a plan of reorganization. The plan provided *inter alia* that United Stores Corporation was to receive, for certain landlord claims purchased by it, common stock at $5.40 per share to the amount of the cost of such claims to it plus incidental expenses. At the same time such common stock was to be subscribed for by the old common stockholders at $6.50 per share which all parties had agreed was a fair value.

United sought to justify its receipt of new common stock at $5.40 a share upon the ground that the claims had a provable value of $7,000,000 in lieu of which they were taking stock up to the amount of its actual cost plus expenses in an amount of $3,130,966.

United had acquired the landlord claims in the following manner. After buying debentures and preferred stock in the open market it enlisted one Hedden's aid to acquire for it such claims which were widely scattered. Hedden, after doing some groundwork towards the corralling of the claims, became a director of McCrory for a short period, during which time he obtained information with reference to what the debtor had accomplished with respect to the claims. Upon his resignation from the board of directors

he was able to purchase all the landlord claims for cash, which claims he then turned over to United.

The court (Patterson, J.) held that the plan was unfair in that it unfairly discriminated in favor of United, and rejected United's argument that its landlord claims were actually being taken at less than their value, saying at page 269:

> "The inference is a fair one that the information relative to settlements which he had obtained while a director was of value to him in acquiring the claims for the United; how much value I cannot say. * * * Under ordinary conditions a director may purchase claims against his corporation at a discount and enforce them for their full amount. Seymour *v.* Spring Forest Cemetery Association, 144 N. Y. 333, 39 N. E. 365, 26 L.R.A. 859; Glenwood Mfg. Co. *v.* Syme, 109 Wis. 355, 85 N. W. 432; Fletcher on Corporation, §2289. But the case is different where the corporation is insolvent and is itself in the field to settle the claims. A director who acquires claims under such circumstances may enforce them for no more than the cost of acquisition. Hedden then was inhibited from making a profit by acquiring claims against the debtor at a discount straightway after resignation and enforcing them at a greater amount. The United is under a like inhibition and must be deemed to hold the claims in trust for the debtor. It may enforce them for no more than it paid the landlords for them together with a reasonable allowance for the expense involved in acquiring them. A constructive trustee is entitled to his necessary expenses within reasonable bounds. Ludington *v.* Patton, 111 Wis. 208, 86 N. W. 571. See, also, Loos *v.* Wilkinson, 113 N. Y. 485, 500, 21 N. E. 392, 4 L.R.A. 353, 10 Am. St. Rep. 495; Wolcott *v.* Commercial Investment Trust, 7 F. Supp. 809, 812 (D.C. N.Y.)."

Ripperger v. *Allyn et al.*, 25 F. Supp. 554 (D.C., S.D., N.Y., 1938), was cited both by the Referee (R. 79) and the District Court (R. 94) as opposed to the foregoing holdings, apparently because of the following dictum in the opinion (p. 555):

> "Directors and those who occupy a similar relation to a corporation may buy up claims held by strangers against it or may purchase from others liens on corporate property without accountability for profits, when the transaction is fair to the corporation and involves no competition with it. The prohibition applicable to strict trustees does not cover such a case."

It does not appear that the corporation there was insolvent nor did the case itself have anything to do with the problem here involved.

The underlying philosophy of the cases we have referred to is to the effect that once a corporation becomes insolvent there arises a situation which so alters the position of its directors as to preclude them from creating any possible conflict of interest with the corporation, its creditors and stockholders and which so disqualifies them from purchasing the corporation's debt securities as to exclude them in a bankruptcy proceeding from receiving more for the securities than they paid for them.

Other authorities are to like effect.

The result for which we contend is recognized by text writers. For example, *Remington on Bankruptcy*, Volume 2, §975.01, at page 69, 1948 Supplement, says:

> "Officers and directors may not while the corporation is insolvent purchase claims against it at a discount and then enforce such claims at their full

face value. The good faith of the fiduciary or his well intended purpose will be no defense. Actual fraud is not necessary. A breach of duty is a constructive fraud."

In Fletcher's Cyclopedia of the Law of Corporations, Volume 3 (1947 Repl. Vol.) it is stated (p. 247):

"The general rule now seems to be that officers, directors and attorneys of a corporation may not, while the corporation is insolvent, purchase claims against it at a discount and then enforce such claims at their full face value."

The Court's attention is also called to *Bulkley* v. *Whitcomb*, 121 N. Y. 107 (1890), *Bramblet* v. *Commonwealth & Lumber Co.*, 26 Ky. L. Rep. 1176, 83 S. W. 599, 602 (1904); and to *Bonney* v. *Tilley*, 109 Cal. 346, 42 P. 439 (1895).

That such a result will not make whole those from whom the securities are purchased, but rather will inure to the advantage of the estate and, therefore, to the non-selling debenture holders, is beside the point. Likewise it is of no consequence that no harm was done to the debtor.

Given improper conduct on the part of fiduciaries, the question is whether they shall be allowed to retain the fruits of their breach of trust or be deprived of them. As we have seen, the federal courts have consistently made deprivation the penalty.

This is not a novel doctrine. In *Magruder* v. *Drury*, 235 U. S. 106 (1914), the executors under a will were deprived of their commissions for conducting transactions with themselves. Pointing out that the estate was not a loser in these transactions, this Court nevertheless went on to say (p. 120):

"While no wrong was intended, and none was in fact done to the estate, we think nevertheless that upon the principles governing the duty of a trustee, the contention that this profit could not be taken by Mr. Drury owing to his relation to the estate, should have been sustained."

Similarly in *In Re Real Estate Mortgage Guaranty Co.*, 55 F. Supp. 749 (D.C., E.D., Pa., 1944), Judge Kirkpatrick discussed the question of whether an equity receiver should be deprived of his compensation for self-dealing and made the comment (p. 752):

"The doctrine that a receiver may not retain a personal profit made out of his trust is a prophylactic rule. It implements the law's precept that a trustee must give undivided loyalty to his trust. The surcharge is the sanction."

Like language is found in Judge Kirkpatrick's decision in *In Re Philadelphia & Western Ry. Co., supra,* where the court said (p. 740):

"The rule is one of policy and is in general the same as that laid down by the Supreme Court in Magruder *v.* Drury, 235 U. S. 106, 35 S. Ct. 77, 82, 59 L. Ed. 151, 'It is a well-settled rule that a trustee can make no profit out of his trust. * * * It makes no difference that the estate was not a loser in the transaction * * *. It is the relation of the trustee to the estate which prevents his dealing in such way as to make a personal profit for himself.' It is proper to say of the respondents in this case that no wrong was intended and none was, in fact, done to the debtor, but that is precisely what the Supreme Court said of the defendant in the Magruder case, supra. If a trustee may use his positon and the inside information which

he has acquired to his own advantage in cases where there is no conflict with the interests of his cestui que trust, the temptation will always be present to do so in cases where there is such conflict. That is the basis of the rule and it applies in this case although there is no charge, no evidence and no suggestion of fraud, overreaching or of any harm to the debtor."

Judge Hand in his dissenting opinion below (R. 186) put the thought as follows:

"I can see no apparent anomaly in distributing the profits on a director's purchase among the creditors at large, when they cannot be returned to the seller. However, it appears to me an excuse for doing so that, if equity regards the bonds as improperly acquired, it is more nearly just to distribute any profits among the other creditors, who have not been paid in full, than to leave them in the director's hands; for they are a part of the bankrupt's assets and the creditors have a better claim to them than the director himself."

In other words the reason for the rule of deprivation of profits in the case of a wrong doing fiduciary is not to enrich the estate but to punish the fiduciary, and such was the result in all of the cases which we have discussed.

For this reason it is immaterial that certain of the sellers of the debentures were Mr. Kelly (the president of the debtor), Mr. Hays (a director) and the King Estate and the Y. W. C. A. (who had kept in contact with the affairs of the corporation). As we have pointed out, there is no evidence as to just what information these four sellers had, nor does it make any difference in view of the principal which has heretofore been uniformly adopted by the federal courts.

As a matter of fact this precise situation was presented in *In Re Los Angles Lumber Products Co., Ltd., supra,* where the director, Faries, purchased some of the bonds in question from the secretary to the president (46 F. Supp. at p. 82) and in conjunction with the brokerage firm made additional purchases from the president and associates of the president (p. 83). No distinction was made by the court between those bonds and bonds purchased from the public at large.

No suggestion was made in either the opinion of the Referee (R. 79-80) or the opinion of Judge Goddard (R. 91-95) that these particular sellers stood in any different position than the other sellers. It was only in the Court of Appeals that such a distinction was made and that was due to the circumstance that the majority felt that it was necessary to demonstrate an over-reaching of the sellers in order to require the imposition of the sanction (R. 184-185)*. If the principle is to have such an exception, it will be necessary to scrutinize each particular purchase by a director, with the practical result that the efficacy of the rule will be destroyed.

It may be that here, as in the courts below, the respondents will argue that the activities of the Becker-Fribourg group, in lending money to the debtor and keeping it alive through its difficult last years until a satisfactory sales price was received, were beneficial to the debtor and that therefore they should not be penalized. Such a contention was rejected by Judge Patterson in *In Re McCrory Stores Corporation, supra,* where he said (p. 269):

> "It is true that if some one with money had not appeared on the scene and reduced the scattered

---

* Judge Learned Hand in dissenting seems to have followed the majority in making the distinction (R. 188).

claims of landlords to a single control, reorganization of the debtor would have been a most difficult task. It is also true that the present plan of reorganization is vastly more favorable to creditors and stockholders than the plan to which the debtor was then committed under its contract with the Chicago group. It may well be that the creditors and stockholders are better off because of the United's activities in the situation. These matters, however, have no legal significance."

The same thought is expressed in *In Re Los Angeles Lumber Products Co., Ltd., supra,* 46 F. Supp. at page 88, where incidentally the court quotes the foregoing language from the *McCrory* case.

The Referee and the District Court erroneously relied upon certain New York decisions, which are neither in point nor authoritative in a bankruptcy proceeding.

The Referee held (R. 79) that a director may acquire for himself unmatured obligations of his insolvent corporation and enforce them for their full face amount, provided that the debtor has not provided any special fund to pay such obligations, that no special liquidation had been ordered, that the debtor was not in the field to settle its obligations, that their acquisition was not unfair to the debtor and that there was no over-reaching.

In support of this holding the Referee cited three New York cases (R. 79) *Seymour* v. *Spring Forest Cemetery Ass'n., et al.,* 144 N. Y. 333; *Claire Neon Lights, Inc.* v. *Federal Electric Co. Inc.,* 250 App. Div. N. Y. 510, 517; and *Hauben* v. *Morris,* 255 App. Div. N. Y. 35, 46, aff'd. 281 N. Y. 652. In none of these cases, however, did it appear that the corporation was insolvent. The Referee

did not cite *Bulkley* v. *Whitcomb*, 121 N. Y. 107 (1890), where the court said (p. 111):

> "As a director of the company, owing to it the duty of acting in its interest and for its benefit, he could not buy up its outstanding debts for his own benefit, *knowing it to be insolvent*, and intending thus to get an advantage over other creditors, and hold the debts purchased for their full amount."

However, New York decisions, even if to the contrary, would not govern since, as the Court of Appeals held in this case (R. 176-177), federal law controls the distribution to creditors in bankruptcy. The court cited *Prudence Realization Corp.* v. *Geist*, 316 U. S. 89; *American Surety Co.* v. *Sampsell*, 327 U. S. 269, 272; *Heiser* v. *Woodruff*, 327 U. S. 726, 732; *Vanston Committee* v. *Green*, 329 U. S. 156, 161-163.

Judge Goddard, in addition to the cases relied upon by the Referee, also cited *Moore Construction Co.* v. *U. S. Fidelity & Guarantee Co.*, 293 N. Y. 119; *Inglehart* v. *Thousand Islands Hotel*, 32 Hun 377 and *Oelbermann* v. *N. Y. & Northern R. Co.*, 14 Misc. 131 (R. 94).

These cases likewise did not involve insolvent corporations and in any event were not applicable because, as we have stated, this is a matter of federal bankruptcy law.

The Referee misapprehended this Court's decision in Securities and Exchange Commission v. Chenery.

The Referee also held (R. 80) that the decision in *In Re Los Angeles Lumber Products Co. Ltd., supra*, could not be taken as an authority, being at variance with this Court's decision in *Securities and Exchange Commission* v. *Chenery*, 318 U. S. 80.

The *Chenery* case involved the reorganization of a public utility under Sections 6 and 11 of the Public Utility Holding Company Act of 1935. The subject company *was not insolvent* but was being reorganized in order to divest itself of certain subsidiary companies in accordance with the provisions of that statute.

The Securities and Exchange Commission had approved a plan of reorganization only after having insisted that the plan be amended to provide that the directors of the old company, who had purchased a sufficient number of its preferred shares to give them control of the reorganized company, should receive in exchange for such preferred shares only the cost of such shares in lieu of shares in the reorganized company. On appeal the Court of Appeals for the District of Columbia held that the directors' preferred stock was entitled to share ratably with the other preferred shares. This Court, in turn, reversed the Court of Appeals and remanded the matter to the Commission. In doing so this Court pointed out that the Commission had reached its result on what it conceived to be broad equitable principles. The court went on to say (p. 88):

> "As the Commission concedes here, the courts do not impose upon officers and directors of a corporation any fiduciary duty to its stockholders which precludes them, merely because they are officers and directors, from buying and selling the corporation's stock."

However, in remanding this Court stated that it felt such a limitation on directors might be within the rule making power of the Commission as an administrative agency under the statute.

The Commission having again reached the same result, this time based on its powers under the Public Utility Holding Company Act of 1935, this Court in a second decision, 332 U. S. 194, sustained the result on the ground that it was within the Commission's powers. This second decision is not the one to which the Referee referred in his opinion.

It is manifest that the *Chenery* case has nothing to do with the problem here at bar. Moreover, the question of the purchase of securities of an *insolvent* corporation was not there presented. The distinction we make was made by Judge Kirkpatrick in *In Re Philadelphia & Western Railway Co., supra,* where he said (p. 740):

> "The respondents contend that the Supreme Court in its decision in Securities and Exchange Commission v. Chenery, supra, announced the broad rule that directors and officers of a corporation in reorganization may traffic in the securities of the corporation. However, in that case the reorganization was under the Public Utilities Act, 15 U.S.C.A. §70 et seq. Moreover the corporation was not insolvent and, as pointed out, courts of equity have never regarded the directors and officers of a solvent going corporation as trustees in the full sense of the word."

The District Court erroneously applied a so-called "going concern" theory.

As we have previously pointed out (p. 15, *supra*), the gist of Judge Goddard's opinion was that, while it has been held that officers, directors and attorneys of a corporation, while the corporation is insolvent, may not purchase claims against it at a discount and then enforce such claims in bankruptcy proceedings at their full face

value, such cases do not seem to cover a situation where the corporation, although insolvent in the bankruptcy sense, is still a *going concern*.

There is no authority in the federal bankruptcy cases for this "going concern" theory. The cases relied upon by Judge Goddard in support of it (R. 94) were all New York decisions which, as we have pointed out (p. 41, *supra*) involved solvent corporations. Moreover, as we have said (p. 41, *supra*), this is a matter of federal bankruptcy law and not state decision.

However, assuming for the moment the correctness of Judge Goddard's qualification, the debtor was at no time during the period here involved a going concern in any true sense. It was insolvent, both under the bankruptcy and equity definitions, and would have collapsed had not the Becker-Fribourg group kept it alive.

The respondents first advanced $15,000 (the Baset mortgage) under terms and conditions which resulted in their obtaining control of the debtor, and thereafter from time to time paid the debtor's real estate taxes, which the debtor itself was unable to pay, in amounts aggregating $7,921.63. At no time did they make any demand for payment of interest on the Baset mortgage.

After October 1943, when Baset took an assignment of rents and operated the property as mortgagee in possession (which was prior to the purchase by the respondents of the greater part of their debentures), *the debtor was no longer conducting any business at all.*

Put briefly, what the respondents did was to get complete control of the debtor by advances aggregating slightly under $23,000, all of which were ultimately repaid in full with interest on the Baset mortgage, while they were acquiring in the aggregate $147,300 of the debtor's

debt securities for a total purchase of $10,195.43, on which they stand now to make a profit of over $54,000.

The life of the debtor could have been terminated at any time by the Becker-Fribourg group and it was a "going concern" only to the extent they chose to permit it to continue to exist and advanced moneys to that end. It manifestly was their purpose to keep the debtor alive until they could acquire at nominal prices its debt securities, against the time when a purchase price for the realty satisfactory to them should be received.

Summary

It is therefore submitted that as a matter of principle and consistent ruling in the federal courts, the directors of an insolvent corporation may not purchase its debt securities and enforce them in bankruptcy at their full face amount, and it is immaterial that there was no overreaching of the sellers nor hurt to the debtor. This is a sanction which implements the law's precept that a trustee must give undivided loyalty to his trust.

II

As the directors themselves were disqualified to purchase the debt securities of their insolvent corporation, such persons as these respondents, related to them, affiliated with them or acting in conjunction with them, likewise cannot profit from any dealings in such securities.

We have heretofore contended that the directors of a corporation may not purchase its debt securities while the corporation is insolvent and enforce them in bankruptcy

at their full face value, but are limited to the actual cost of such securities and interest.

This disqualification extends to these respondents one of whom is the mother of the two Becker brothers, another the wife of one of them, and the third a business affiliate who acted throughout in conjunction with all four members of the Becker family.

The case of the Becker ladies is quite clear, and the Referee, the District Judge, and the three judges of the Court of Appeals agreed that if the directors themselves were disqualified, the Becker ladies would likewise be disqualified.

The Referee found as a matter of fact that the Becker brothers had acted as agents for the Becker ladies in the purchase of their debentures and that the proof did not warrant a finding that the ladies had exercised any discretion of their own in such purchases (F. 53, R. 77). He then found as a conclusion of law that the proofs of debt of the Becker ladies should be treated as if they were proofs of debt filed by directors of the debtor (Third Conclusion, R. 78).

The District Court did not disagree (R. 93). The majority of the Court of Appeals said (R. 185):

> "As respects the Becker ladies, since they exercised no independent judgment in the investment of their funds, they are chargeable with the knowledge of their agent, Sanford Becker."

Judge Learned Hand said of the Becker ladies (R. 188):

> "They relied altogether upon the directors' advice and exercised no judgment of their own in deciding to buy. In so doing I think that they became charged with the same equities that would have

charged the directors, had they bought on their own behalf. In short, the directors could not pass on to their principals profits which they could not have retained for themselves."

The case as to Fribourg is almost as clear.

As we have pointed out (p. 5, *supra*), Fribourg was a business affiliate of Sanford Becker and maintained his office in the suite occupied by Sanford and Norman Becker and shared a room there with Norman Becker.

Both Sanford Becker and Fribourg had purchased debentures of the debtor by the end of 1941 (R. 9, 62). When Sanford Becker brought suit to restrain a sale of the debtor's property to Chesterbrook Estates in early 1942 (F. 16-17, R. 71), Fribourg participated to the extent of furnishing an affidavit (R. 22).

When the stockholders failed to approve the sale to Chesterbrook Estates on February 17, 1942, Sanford Becker presented a proposal to lend the debtor a sum necessary to clear up the defaults on the Poughkeepsie Savings Bank mortgage ($15,000). This offer was made on behalf of "a client of mine" (Obj. Ex. 7, R. 60-61). "Client" referred to these respondents (R. 12). Baset Realty Corporation was organized for the transaction and was owned and controlled by the three respondents, the advance being made by the three in equal shares (R. 12-13; F. 20, R. 72).

It was through the Baset loan that the Becker-Fribourg group obtained ultimate control of the debtor, as we have previously explained (*supra*, pp. 5-8). Later, advances for taxes were similarly made by the three respondents jointly through Baset (R. 33-35; F. 21, R. 72).

As we have also pointed out (*supra*, pp. 8-9) the acquisition of the debentures by the three respondents was

effected as a concerted effort, Regine Becker's debentures all being purchased through Fribourg's account with E. Henry Sondheimer & Co., part of Emily K. Becker's debentures being acquired in like fashion and a considerable part of Fribourg's debentures being acquired as a result of the Winter letter, a matter which was handled by Norman Becker.

While the Referee held that Fribourg's proof of debt should not be treated as if it were a proof of debt filed by a director (First Conclusion, R. 78), the District Court felt otherwise (R. 93).

The majority of the Court of Appeals felt that nothing in the record justified a finding that Fribourg did more than invest his own funds on a "tip" received from an officer or director of the debtor (R. 185). Judge Learned Hand expressed no opinion on the subject (R. 188).

This conclusion below seems inconsistent with that reached by the same court in a subsequent decision, *Berner* v. *Equitable Office Bldg. Corporation*, 175 F. 2d 218 (1949). That was an appeal from an order in bankruptcy which denied any allowance to one Berner, who was attorney for the shareholders of the debtor in a Chapter X reorganization. The question arose under Section 249 of the Bankruptcy Act, 11 U.S.C. 649, which so far as there pertinent provides as follows:

> "No compensation or reimbursement shall be allowed to any committee or attorney, or other person acting in the proceedings in a representative or fiduciary capacity, who at any time after assuming to act in such capacity has purchased or sold such claims or stock, or by whom or for whose account such claims or stock have, without the prior consent or subsequent approval of the judge, been otherwise acquired or transferred."

The Court of Appeals held that there was no proof of conduct "which necessarily forfeited his rights under §249, or under general equity principles", but concluded that there was proof of conduct which required his allowance to be reduced in an amount which the District Court should fix in its discretion. It appeared that one Bell had purchased stock of the debtor during the proceedings on the basis of information received from Berner. The court's opinion, written by Judge Learned Hand, discusses the duties of fiduciaries and then continues (pp. 221-222):

> "Even were this not a general principle of the law of trusts, since Congress has seen fit in corporate reorganizations to impose so drastic a penalty as the forfeiture of all compensation upon any purchase whatever by an attorney—or other fiduciary—on his own account, we should fail to give proper scope to that purpose, if we were to say that he might freely favor a relative, or indeed even a friend, with information of a probable rise in price of the debtor's shares which was unknown to the shareholders. We hold that this is what Berner did, and that in so doing he committed a breach of trust to the shareholders of whom Bell bought."*

What Berner did there was really to give no more than a "tip" to his friend Bell (cf. p. 221), whereas in the instant case there was active cooperation between the directors and Fribourg.

The fact that that decision was rendered with respect to Section 249 does not distinguish it because, as hereafter pointed out, the matter is one of the equitable powers of

* Judge Swan, who wrote the majority opinion below in the instant case, concurred in this opinion.

the bankruptcy courts, irrespective of particular provisions in the act such as that particular section.

A situation similar to that at bar was presented in *In re Los Angeles Lumber Products Co., Ltd., supra,* where, it will be remembered, a brokerage concern, District Bond Company, cooperated with the director Faries in purchasing bonds of the debtor. It appeared, as here, that the District Bond Company knew that Faries was a director and was familiar with the debtor's affairs. The court decided that under the circumstances the District Bond Company was not to be treated in any way differently than Faries, citing this Court's decision in *Jackson* v. *Smith,* 254 U. S. 586.

In *Jackson* v. *Smith* a receiver for a building association arranged with his attorney and an outsider, one Wilson, that Wilson should puchase property of the association at a foreclosure sale for the joint account of all three. The foreclosure was held, was fairly conducted, there was competitive bidding, and the property was finally knocked down to Wilson as the highest bidder. Subsequently it was resold at a profit.

This Court held that under the circumstances the receiver and his associates, including Wilson, were accountable to the trust estate for all the profits realized, saying (p. 589):

> "Wilson and Smith (the receiver's attorney) are therefore jointly and severally liable for all profits resulting from the purchase; *the former although he had no other relation to the estate; the latter, without regard to the fact that he was also counsel for the receiver.*"

The principle enunciated by this Court in *Jackson* v. *Smith* is quite pertinent to Fribourg's situation here, and

it may be added that that decision is of additional interest because it appears that there the receiver obtained the best price offered at a fairly conducted open competitive sale.

A somewhat similar situation was presented in *In re Jersey Materials Co., supra,* the force of the authority being weakened, however, by the circumstance that the court stated (50 F. Supp. at p. 31) that he was persuaded that the third party had purchased the debt there involved with the intent that the director should benefit thereby, a circumstance which is not present in this case.

However, the basic consideration is that third parties who become affiliated must bear the burden of that affiliation. So, for example, in *In Re Midland United Co.*, 159 F. 2d 340 (3 Cir. 1947), a reorganization proceeding under Section 77B of the Bankruptcy Act, the wife of a fiduciary was held disqualified to purchase the debtor's securities even though she had financed her dealings entirely with her own funds (cf. p. 347), as was also the case with the respondents at bar.

This decision is of additional interest. The fiduciary himself was disqualified, having purchased securities of a subsidiary of the debtor which was at the same time a creditor of the debtor, and the court held that such disqualification was independent of any statutory sanction, saying (p. 346):

> "However, independent of Section 249 (of the Bankruptcy Act), we hold that appellant is barred from recovery under the principles enunciated in the Woods and the Avon Park cases. They hold, as already pointed out, that the bankruptcy court had plenary power to deny compensation to a fiduciary in a reorganization proceeding 'where an actual

conflict of interest exists' regardless of whether 'fraud or unfairness' resulted.

The appellant does not dispute the fact that he was a fiduciary for Utilities' debenture holders and that as such he owed them a duty of loyalty. It is necessary, then, only to ascertain from the record as to whether or not there was an actual conflict of interest."

The *Woods* case is *Woods* v. *City National Bank & Trust Co. of Chicago*, 312 U. S. 262 (1941). The *Avon Park* case is *American United Mutual Life Insurance Co.* v. *City of Avon Park*, 311 U. S. 138 (1940).

While these cases are not in point factually, they do exemplify the principle that the federal bankruptcy courts are entrusted with substantial equity power directed to the prevention of injustices and to the furtherance of fair dealing. The thought is expressed in this Court's opinion in *Pepper* v. *Litton*, *supra*, where it said (308 U. S., at p. 306):

> "That equitable power also exists in passing on claims presented by an officer, director, or stockholder in the bankruptcy proceedings of his corporation. The mere fact that an officer, director, or stockholder has a claim against his bankrupt corporation or that he has reduced that claim to judgment does not mean that the bankruptcy court must accord it *pari passu* treatment with the claims of other creditors. Its disallowance or subordination may be necessitated by certain cardinal priciples of equity jurisprudence. A director is a fiduciary."

This Court further said (p. 307):

> "In the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice

or unfairness is not done in administration of the bankrupt estate."

See also *In re Kansas City Journal-Post Co.*, 144 F. 2d 791 (8 Cir. 1944), where the court said (p. 803):

> "For claim and distribution purposes, a bankruptcy proceeding is an integrated proceeding, and the 'subject matter in litigation' in its practical aspect is the right of creditors to share in the bankruptcy assets themselves, not merely legally but in equitable relation to each other—for the assertion of a claim in bankruptcy is, of course, not an attempt to recover a judgment against the debtor but to obtain a distributive share in the immediate assets of the proceeding. The inequity which will entitle a bankruptcy court to regulate the distribution to a creditor, by subordination or other equitable means, need not therefore be specifically related to the creditor's claim, either in its origin or in its acquisition, but it may equally arise out of any unfair act on the part of the creditor, which affects the bankruptcy results to other creditors and so makes it inequitable that he should assert a parity with them in the distribution of the estate; and with the most critical force may the application be made where a fiduciary relation is involved."

The Court of Appeals below pointed out (R. 185) that in *In Re Philadelphia & Western Railway Co., supra*, the court declined to limit the claim of the father of an officer of the debtor corporation and of a claimant who was an officer of a corporation which had a management contract with the debtor for the management of the debtor's business. An examination of Judge Kirkpatrick's opinion on that point (64 F. Supp. at p. 741) does not disclose any detail of facts, but it would seem fair to assume that there

was no concerted action between the two claimants and the fiduciaries such as occurred in the present instance. It does not appear, for example, that there the fiduciary acted as agent for his father in the purchase of his father's bonds, nor that the other creditor in any way acted in concert with directors of the debtor in the purchase of her bonds. Such circumstances are present in the case at bar beyond any shadow of a doubt.

It may be that not every relative or every affiliate or business associate of a fiduciary is disabled from dealing in the securities of the fiduciary's corporation, even though insolvent. We do claim, however, that where facts are presented such as here appear, there can be no question but that the disability applies to the purchasers as well as to the fiduciaries. Any other conclusion would open wide the door to the very sort of situation which the bankruptcy courts have sought jealously to eliminate.

Obviously, to permit these fiduciaries to conduct transactions forbidden to them, by acting as agents for the mother and wife, and by cooperating with the third respondent, in the purchase of the securities acquired by them, would be to make a travesty of the basic rule and encourage the very thing which the rule forbids.

CONCLUSION

It is respectfully submitted that the orders of the Court of Appeals for the Second Circuit, the District Court of the United States for the Southern District of New York and the Referee in Bankruptcy should be reversed and that the claims of the respondents (except as to $5,000 of the Fribourg claim) should be limited to the amounts paid by them respectively for their debentures.

Dated: New York, N. Y., September 20, 1949.

Respectfully submitted,

EDWARD K. HANLON,
Counsel for Petitioner.